The Commonwealth of Massachusetts

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

December 29, 2004

D.T.E. 02-79/03-124/03-126

Petition of Massachusetts Electric Company, Nantucket Electric Company, and New England Power Company for approval of an offer of settlement intended to resolve all issues pending in the following dockets: D.T.E. 02-79; D.T.E. 03-126; and D.T.E. 03-124.

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FOR: MASSACHUSETTS ELECTRIC COMPANY, NANTUCKET ELECTRIC COMPANY AND NEW ENGLAND ELECTRIC COMPANY
Petitioner

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I. INTRODUCTION

On November 18, 2004, Massachusetts Electric Company, Nantucket Electric Company (together, "MECo" or "Company"), New England Power Company ("NEP"), and the Attorney General of the Commonwealth (collectively, the "Parties") filed an offer of settlement ("Settlement") intended to resolve all issues in MECo's last two reconciliation filings, Massachusetts Electric Company and Nantucket Electric Company, D.T.E. 02-79 and Massachusetts Electric Company and Nantucket Electric Company, D.T.E. 03-126, as well as the Company's exogenous cost filing, Massachusetts Electric Company and Nantucket Electric Company, D.T.E. 03-124 (Settlement at 1).[1] The Settlement will be withdrawn unless it is approved by the Department on or before December 30, 2004.

On December 2, 2004, the Department issued a Request for Comments. On December 13, 2004, comments were submitted by the Division of Energy Resources ("DOER"), the Northeast Energy Efficiency Council, and The Energy Consortium (collectively, the "Restructuring Signatories"); Constellation NewEnergy ("Constellation") and Dominion Retail, Inc.("Dominion") (collectively, the "Commenters"), the Massachusetts High Technology Council Inc. ("MHTC") and Select Energy ("Select"). The Company filed reply comments on December 17, 2004.[2] The evidentiary record from D.T.E. 02-79 consists of 23 exhibits and three responses to record requests. The evidentiary record for D.T.E. 03-124 consists of 36 exhibits and four responses to record requests. The evidentiary record for

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[1] The Settlement is also accompanied by a Motion to Consolidate the three dockets, which the Department herein grants.

[2] The Massachusetts Health and Education Facilities Authority filed late comments on December 22, 2004. The Company responded on December 23, 2004.

D.T.E. 03-126 consists of 29 exhibits. On its own motion, the Department moves into the record in this consolidated proceeding all of the exhibits from the three individual dockets as well as the Company's responses to 16 Department information requests regarding the Settlement.

II. DESCRIPTION OF SETTLEMENT

The proposed Settlement includes a customer credit of approximately $19.9 million that will be used to reduce customer bills during the first twelve months after the end of standard offer service (Settlement at Article 2(a)). The customer credit consists of:

- $1.4 million to resolve all issues associated with the reconciliation of power supply costs concerning the misclassification of certain customers on default service, which is at issue in D.T.E. 02-79 and D.T.E. 03-126. This amount will be returned to customers through the default service adjustment charge (id.).

- $8.5 million associated with exogenous events under MECo's merger agreement, approved in Massachusetts Electric Company/Eastern Edison Company, D.T.E. 99-47 ("Merger Agreement"), which consists of:

    - $2.1 million for bonus depreciation accrued through 2003 and $4.6 million for bonus depreciation accrued for the period January 1, 2004 through February 28, 2005 (Settlement at Article 2(a));[3] and

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[3] Congress amended Internal Revenue Code Section 168(k) ("IRC 168(k)") by enacting the Job Creation and Worker Assistance Bill of 2002. IRC 168(k) provides for accelerated depreciation deduction for property acquired after September 10, 2001 and before September 11, 2004, in addition to the depreciation deduction a company is allowed in the property's first year pursuant to the Modified Accelerated Cost Recovery System. IRC § 168(k). MECo states that bonus depreciation is an exogenous cost because (1) it is an externally imposed federal regulatory change that causes the Company's deferred income taxes to increase, which in turn results in it having a lower rate base and a higher return on equity, and (2) MECo's return on equity increased as a result of a change in the tax code beyond the exogenous cost threshold of $1 million stipulated in the Merger Settlement (D.T.E. 03-124, Exh. MEC-1, at 54-63).

- $1.9 million associated with estimated reduction in FAS 106 expense under the Medicare Act of 2003[4] for the period July 1, 2003 through February 28, 2005 (id.).

These amounts will be returned to customers using a factor of 0.38 cents per kilowatthour ("KWH") applied to all KWH billed for retail delivery service over twelve months, commencing in March 2005. The estimated costs will be reconciled when those amounts are known (id.).

- $9.0 million associated with resolving wholesale issues concerning NEP charges to MECo that are recovered through the contract termination charge ("CTC"), which MECo recovers from its retail customers through the transition charge (id.)

- $0.9 million associated with resolving a 2004 transmission capital structure issue that NEP also recovers from MECo through the CTC (id.).

The last two credits ($9.0 million associated with wholesale issues and the $0.9 million associated with transmission) are subject to the Federal Energy Regulatory Commission's ("FERC") jurisdiction and are reconciled in a FERC proceeding (Settlement at Article 9).

The Parties have also agreed to keep the standard offer service rate at its current level of 6.802 cents per KWH through the end of the transition period (Settlement at Article 2(b)). At the end of standard offer service, the Company is estimated to have an under-recovery of $43.7 million in standard offer service costs (id. at Article 2(c)). Consistent with MECo's restructuring settlement approved in Massachusetts Electric Company, D.P.U. 96-25 (1997) ("Restructuring Settlement"), MECo agrees to defer recovery of these standard offer service costs until 2010 at an interest rate equal to the customer deposit rate (id.). In addition, the Settlement requires MECo to defer to 2010 with interest at the customer deposit rate the recovery of an estimated $22.6 million of supply-related costs (e.g., congestion costs,

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[4] The Medicare Act of 2003 lowers a company's post-retirement benefit other than pension expenses.

generation information systems, etc.) which the Company had proposed to be recovered in D.T.E. 03-124 (id.).[5]

MECo claims that the economic value of the Settlement to the Company's customers is $71.2 million, consisting of:

- $19.9 million in customer credits as described above;
- $33.1 million in the difference in carrying costs at the customer deposit rate (currently at 1.65 percent) and at MECo's cost of capital (currently at 13.09 percent) for the deferral of standard offer service costs for the period March 1, 2005 through January 1, 2010; and
- $18.2 million in the difference in carrying costs at the customer deposit rate and at MECo's cost of capital for the deferral of $22.6 million in supply-related costs for the period March 1, 2005 through January 1, 2010 (Cover Letter at 1-3).

III. POSITION OF THE COMMENTERS

A. Restructuring Signatories

The Restructuring Signatories object to the portion of the Settlement that would collect the standard offer service under-recovery through distribution rates (Restructuring Signatories' Comments at 1-2). The Restructuring Signatories state that the Department should reconsider Section I.B.5(b) of the Company's Restructuring Settlement that requires under-recovered standard offer service costs to be deferred until 2010 and then collected from all retail delivery customers (id.). Specifically, the Restructuring Signatories argue that Section VII.D of the Company's Restructuring Settlement provides that portions of the Restructuring Settlement may be rendered ineffective due to subsequent regulatory and legislative actions (id. at 2). The

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[5] The Parties also represent that they will collaborate to develop a method for (1) identifying and tracking merger savings and synergies and (2) measuring electric utility productivity (Settlement at Article 5).

Restructuring Signatories assert that the enactment of the Electric Industry Restructuring Act, the creation of default service, the creation of congestion and Renewable Portfolio Standard costs, and the Department's Orders directing that standard offer service and default service rates reflect the full costs of providing those services are regulatory and legislative actions that render Section I.B.5(b) ineffective (id. at 2-3).

The Restructuring Signatories urge the Department to direct MECo to recover the under-recovered standard offer service costs through a surcharge on default service rates only from those default service customers who convert to default service on March 1, 2005 (i.e., current standard offer service customers) (id. at 2-3). According to the Restructuring Signatories, the next best alternative would be to impose a surcharge on default service rates for all default service customers with a short recovery period of twelve to 24 months to be consistent with keeping the rate impacts reasonable. MHTC, Select and the Massachusetts Health and Education Facilities Authority submitted comments that endorsed the Restructuring Signatories' comments.

B. Constellation and Dominion

Constellation urges the Department to reject the Settlement, arguing that it: (1) violates Department precedent requiring standard offer service and default service prices to reflect the full cost of the service; (2) undermines the competitive electric market by subsidizing standard offer service prices through distribution rates; and (3) violates principles of cost causation and equity by recovering past standard offer service costs from future customers more than five years from now (Constellation Comments at 2, 17-18). Constellation also argues that the proposed deferral is not required by the Company's Restructuring Settlement or the Merger

Agreement (id.). Constellation further contends that the Company's Restructuring Settlement and Merger Agreement do not require that standard offer service under-recoveries or deferrals be collected in distribution rates (id. at 11-17). Similarly, Dominion urges the Department to reject the Settlement because standard offer service cost deferrals would adversely affect the development of the competitive electric market (Dominion Comments at 2).

C. MECo

The Company argues that the Restructuring Settlement clearly provides that "[u]nder-recoveries, if any, that remain after the standard offer period ends . . . shall be recovered from all retail delivery customers by a uniform surcharge not exceeding $0.004 per KWH commencing on January 1, 2010" (MECo Reply Comments at 3, citing Restructuring Settlement Section I.B.5(b)). Moreover, the Company argues that there is no evidence to support the Commenters' suggestion that MECo's Restructuring Settlement in general, or Section I.B.5(b) of the Restructuring Settlement in particular, be set aside or modified (id.). Further, MECo asserts that the Commenters' argument that Section VII.D of the Restructuring Settlement (which provides that aspects of the Restructuring Settlement may be rendered ineffective by subsequent regulatory and legislative actions) should be rejected (id. at 5). Specifically, the Company argues that, contrary to the Restructuring Signatories' assertion (1) default service did exist when the Restructuring Settlement was signed, with the only difference being that default service was then called "basic service;" and (2) although the competitive supply market for electricity has been slow to develop despite widespread optimism when the Restructuring Settlement was executed, an anemic competitive market does

not render Section VII.D ineffective.[6] Indeed, the Company asserts that the Restructuring Settlement provides for deferrals in the event of standard offer service under-recoveries and sets no conditions on the state of the competitive market that would render the deferral provision ineffective (id. at 6).

Regarding the Commenters' suggestion to recover the standard offer service under-recovery in the twelve months after standard offer service terminates by imposing a surcharge on former standard offer service customer, MECo contends that this would (1) lead to higher rates and customer dissatisfaction and (2) would not produce a "better price signal" but rather a "higher price" (id.). Therefore, MECo argues that the Department should reject these arguments and base next year's default service prices on the current costs that are associated with the winning default service bids (id.).

Regarding Constellation's argument that the deferrals of supply cost recovery violates principles of equity and cost causation, MECo responds that the issue is moot: the Department approved this method of cost recovery when the Restructuring Settlement was approved. Moreover, the Company asserts that the instant Settlement provides for rate stability and continuity for MECo's ratepayers (id. at 7, citing Fitchburg Gas and Electric Light Company, D.T.E. 02-24/25, at 357 (2002)). Last, regarding Constellation and Dominion's arguments that the Settlement's standard offer cost deferrals will undermine the competitive supply market and that, therefore, the Company should impose surcharges on default service customers who

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[6] The Company argues that because the Restructuring Signatories are objecting to one provision of the Restructuring Settlement the deferral provision is not rendered ineffective (MECo Reply Comments at 6).

switched from standard offer service, MECo responds that such an alternative would (1) fail to send the correct price signal and (2) artificially inflate default service prices (id. at 8).

IV. STANDARD OF REVIEW

In assessing the reasonableness of an offer of settlement, the Department reviews the entire record as presented in a company's filing and other record evidence to ensure that the settlement is consistent with applicable law, including relevant provisions of the Restructuring Act, Department precedent, and the public interest. Boston Edison Company, D.P.U./D.T.E. 96-23, at 13 (1998); Berkshire Gas Company, D.P.U. 96-92, at 8 (1996); Boston Gas Company, D.P.U. 96-50, at 7 (Phase I) (1996). A settlement among the parties does not relieve the Department of its statutory obligation to conclude its investigation with a finding that a just and reasonable outcome will result. Essex County Gas Company, D.P.U. 96-70, at 5-6 (1996); Fall River Gas Company, D.P.U. 96-60, at 5 (1996).

V. ANALYSIS AND FINDINGS

The Settlement returns to MECo's ratepayers during the first year $1.4 million in misclassified default service costs, $8.5 million in exogenous costs, and $9.9 million in costs collected through the CTC. Each of these provisions of the Settlement lowers rates in the first year. The Department finds that, overall, the Settlement is consistent with the Restructuring Settlement, Merger Agreement, and Department precedent and, on balance, represents a reasonable resolution of these issues. NSTAR Electric Company, D.T.E 03-121, at 49 (2004).

The remaining components of the Settlement primarily relate to the standard offer service rate and the deferral of standard offer service costs. The Restructuring Signatories and Commenters opposed deferring collection of the unrecovered standard offer service costs for

five years and instead urged the Department to increase the supply component of rates immediately to recover these costs. Among the reasons provided by the Restructuring Signatories and Commenters for opposing the deferral were that (1) the deferral is not consistent with the Company's Restructuring Settlement, and (2) the deferral is anti-competitive and stunts the development of a competitive market.

With respect to the Restructuring Signatories and Commenters' argument that the deferral is not consistent with the Restructuring Settlement, both agree that Section 1.B.5(b) of the Restructuring Settlement provides that unrecovered standard offer service costs at the end of the standard offer service period shall be deferred until 2010, which is consistent with the Settlement's treatment of unrecovered standard offer service costs. However, the Restructuring Signatories and Commenters assert that pursuant to Section VII.D of the Restructuring Settlement, Section 1.B.5(b) is no longer effective because of intervening regulatory actions (e.g., Department Orders regarding standard offer service and default service).

We disagree that subsequent regulatory actions have rendered Section 1.B.5(b) moot. Contrary to Constellation's assertion, when the Restructuring Settlement was executed and approved, default service did exist. Default service was simply then called "basic service" (Restructuring Settlement, Section I.B.7). Moreover, the treatment of deferrals required by the Restructuring Settlement is not conditioned on the number of customers left on standard offer service or the state of the competitive market. A change in nomenclature or slower than anticipated growth in the competitive supply market does not make Section 1.B.5(b) of the Restructuring Settlement ineffective. In addition, the fact that the the Restructuring Signatories

were parties to the Restructuring Settlement does not require the Department to defer to their interpretation of the Restructuring Settlement.

With respect to the Commenters' argument that the defferal is anti-competitive, we note that unlike default service, standard offer service was a transition service and as such was not intended to reflect the market rate of power. On March 1, 2005, pursuant to G.L. c. 164, § 1 et seq., all standard offer service customers will be transferred to default service. To ensure a smooth transition, it is important that electric rates remain as stable as possible. This Settlement provides for a smooth transition while deferring costs at an attractive interest rate. To add a surcharge onto the default service rate for those customers that were on standard offer service at the time of its termination as suggested by the Restructuring Signatories and Commenters would price default service above the market rate and harm customers. Therefore, the Department finds the Settlement's standard offer deferral to be in the public interest and consistent with the Company's Restructuring Settlement, the Merger Agreement, the Restructuring Act, and Department precedent.

VI. ORDER

After due notice, hearing and consideration, it is hereby

ORDERED: That the Joint Motion to Approve an Offer of Settlement, submitted by Massachusetts Electric Company and Nantucket Electric Company, New England Power Company, and the Attorney General on November 18, 2004, is hereby ALLOWED.

By Order of the Department,

/s/

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Paul G. Afonso, Chairman

/s/

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W. Robert Keating, Commissioner

/s/

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Eugene J. Sullivan, Jr., Commissioner

/s/

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Deirdre K. Manning, Commissioner

An appeal as to matters of law from any final decision, order or ruling of the Commission may be taken to the Supreme Judicial Court by an aggrieved party in interest by the filing of a written petition praying that the Order of the Commission be modified or set aside in whole or in part. Such petition for appeal shall be filed with the Secretary of the Commission within twenty days after the date of service of the decision, order or ruling of the Commission, or within such further time as the Commission may allow upon request filed prior to the expiration of the twenty days after the date of service of said decision, order or ruling. Within ten days after such petition has been filed, the appealing party shall enter the appeal in the Supreme Judicial Court sitting in Suffolk County by filing a copy thereof with the Clerk of said Court. G.L. c. 25, § 5.